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Hedge Fund and Private Equity Fund Secured Loans and the Volcker Rule

Loans secured by interests in hedge funds and, to a lesser extent, private equity funds have been a staple of many banks' credit offerings for years. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, H.R. 4173) ("Dodd-Frank") in general, and the part thereof known as "the Volcker Rule" in particular, have raised a basic question: "Can a banking institution subject to the Volcker Rule (which is virtually every banking institution in the U.S.) continue to make and enforce hedge fund and private equity fund secured loans?"

On December 10, 2013, the various regulators with jurisdiction over the banking industry (the "Agencies") finally adopted the Volcker Rule,[1] which is the portion of Dodd-Frank intended to prevent banks from engaging in proprietary trading in "covered funds".[2] In addition to the ban on proprietary trading, the Volcker Rule severely restricts banks' ownership in covered funds and certain transactions with affiliated covered funds.

Covered Fund Interests as Collateral

Lenders engaged in the typical hedge fund or private equity secured loan do not want to own the fund interest, even in a default scenario.[3] Their preferred "way out" of the loan upon a default is to redeem the fund interest through the fund's redemption procedure or to sell the fund interest in the secondary market. However, it became apparent during the financial crisis of 2008, when some funds suspended or delayed redemptions due to lack of liquidity and the secondary market all but dried up, that the preferred course of action may not always be available. Therefore, faced with the risk of funds being "gated" and the secondary market evaporating when needed, some banks have increased reliance on the availability of remedies of a secured party, including foreclosure, as part of their credit underwriting for covered fund lending.

When Dodd-Frank was enacted in 2010 and the Volcker Rule was initially proposed, the question of a bank's ability to take a security interest in and to own covered fund interests, even in connection with exercising remedies as a secured party, became relevant. Since the stated purpose of the Volcker Rule is to eliminate proprietary trading by banks and ownership of covered funds, and not to limit a bank's lending products, it stands to reason that the Rule would not restrict a bank's ability to obtain or foreclose on a security interest in a covered fund. However, while the draft Rule contained an exemption to the overall prohibition for an ownership interest that is "acquired or retained by a bank in the ordinary course of collecting a debt previously contracted in good faith," it did not provide any additional guidance on the issue of taking a security interest or disposing of collateral.

[1] The institutions affected by these changes include most of the entities subject to the rules of the regulatory agencies currently involved in monitoring the financial system (i.e., Federal Deposit Insurance Corporation, U.S. Securities and Exchange Commission, Office of the Comptroller of the Currency, Federal Reserve, and Commodities Futures Trading Commission). The final Rule becomes effective April 1, 2014, and the conformance period has been extended an additional year until July 21, 2015.

[2] "Covered funds" are essentially entities that would be investment companies under the Investment Company Act of 1940 but for an exemption thereunder, i.e., private equity and hedge funds.

[3] In a typical loan secured by covered fund interests, the lender will in most instances not take title to the fund interests at the time it makes the loan, but will take a security interest in the fund interests to secure its loan.

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Fortunately, the final Rule expressly exempts from the definition of proprietary trading "[a]ny purchase or sale of one or more financial instruments by a banking entity in the ordinary course of collecting a debt previously contracted in food faith". It also exempts banking entities' acquisition or retention of ownership interests in covered funds in the "ordinary course of collecting a debt previously contracted in good faith."

The Preamble to the Rule[4] addresses this issue in more depth and states that the Agencies believe that the purchase and sale of a financial instrument in satisfaction of a debt previously contracted does not constitute proprietary trading, thereby providing an express exclusion for such purchases and sales of financial instruments. The Preamble goes on to say that the exclusion is necessary for banking entities to continue to lend to customers, because it allows them to engage in lending activity with the knowledge that they will not be penalized for recouping losses should a customer default. In the Preamble, the Agencies expressly cite comments made by industry participants that address the acquisition and disposal of collateral for a debt as a prudent and desirable part of lending and debt collection activities. The Agencies acknowledge this and provide two examples of permissible activities in the Preamble: (i) banking entities, including SEC regulated broker-dealers, will be able to continue to provide margin loans[5] and may take possession of margined collateral following a customer default or failure to meet a margin call and (ii) CFTC-regulated banking entities will be able to take, hold, and exchange collateral on swaps.

Super 23A Restrictions

The "super 23A" restrictions[6] of the draft Rule survive in the final Volcker Rule and prohibit a banking entity from entering into a "covered transaction" with a covered fund if the banking entity serves as investment manager or investment advisor or sponsors a covered fund, among other activities. However, in the Preamble to the final Rule, the Agencies state that the Rule permits margin and securities lending "to a customer secured by shares of a covered fund held in a margin account."[7] The Agencies state that an extension of credit by a banking entity to a third-party customer that is not a covered fund, but that is secured by the shares of a covered fund affiliated with such banking entity, is not subject to the super 23A restrictions because the transaction by the banking entity is not "with" the affiliated covered fund, but rather "with" the unaffiliated third-party customer. As explained in the Preamble, this would appear to permit a lender to secure a loan to a third-party customer with interests even in a sponsored covered fund.[8]

Enforcement of Security Interests

As a secured lender with covered fund interests as collateral, much like the lender in a margin or securities-based loan not involving covered fund interests, a bank's remedies will include a right to foreclose its security interest and take possession and dispose of its collateral. Therefore, if a bank obtains a security interest in a covered fund as collateral in connection with its ordinary underwriting of a loan and takes title in connection with default thereunder and enforcement of a lien (or in lieu thereof), it appears that the Rule expressly sanctions the resulting ownership and sale of the covered fund interest.[9]

[4] The Preamble to the Rule, in the Agencies' own words "discusses many of the issues raised by the commenters and explains the Agencies' responses to those comments."

[5] The Agencies appear to be taking the approach that "margin loans" comprise not only typical margin loans made by broker-dealers, but also securities-based loans made by banks or non-bank lenders other than broker-dealers, as the final Rule does not stipulate that only "broker-dealers" can make margin loans, but rather, indicates in the Preamble that banking entities, <u>including</u> SEC-registered broker-dealers, will be able to continue to provide margin loans and take a position in the margined collateral following a customer's default or failure to meet a margin call (emphasis added). Accordingly, in our view, these specific references are examples of activities that will remain permissible, and the Rule does not limit its application to typical margin loans provided by broker-dealers.

[6] The "super 23A" restrictions essentially adopt the Section 23A restrictions of the Federal Reserve Act on transactions with affiliates, but apply them to all entities in a banking entity's chain (rather than just banks, as Section 23A provides) without certain standard exemptions contained in Section 23A.

[7] Again, in our view, because the final Rule does not specify that a margin account be held at a broker-dealer, the Agencies' intent would appear to be to permit margin loans and securities-based loans by any banking entity, secured by interests in covered funds that are affiliates of such banking entity to be made, subject to any requirements under Section 23A as may be applicable.

[8] The Preamble does warn that "the Agencies expect banking entities not to structure transactions with third parties in an attempt to evade the restrictions on transactions with covered funds."

[9] Although the Volcker Rule also exempts ownership by a bank of covered funds as a custodian, it would appear to limit a bank's ability to take legal title to a covered fund interest as part of its original collateral package, even if it takes title as custodian for itself as a secured lender, because it can act only as a custodian for an "unaffiliated third party," and, in certain limited circumstances, for an affiliate. Also, because the exemption uses the term "collecting a debt previously contracted" as opposed to "securing a debt," it would appear to permit ownership not as a security mechanism, but only as an enforcement mechanism.

The Rule does go on to require that a bank that acquires an ownership interest in a covered fund "divests the financial instrument as soon as practicable, and in no event may the banking entity retain such instrument for longer than such period permitted by the [Agency]."[10] In our view, this divestiture requirement is similar to the rules applicable to OREO (other owned real estate) for banks, which provides that real property obtained in the foreclosure or other satisfaction of a debt has to be disposed of within five years. Each banking entity will need to look to the rules of its own regulator to determine the appropriate time period for divestiture.

Conclusion

While it is expected that various aspects of the Volcker Rule will be subject to legal challenge,[11] it appears that lending secured by covered fund interests (including interests in affiliated covered funds) and realization by banks on their security interest in such fund interests will be permitted under the current version of the Rule.

[10] Note that the final Rule has added that disposal of the covered fund interest is required "as soon as practicable" and in no event longer than the permitted regulatory holding period, whereas the draft had required disposal only within the time period required by the applicable regulator.

[11] Banking industry organizations have already instituted legal challenges to certain aspects of the Rule.

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